

Letter of Findings Number: 10-0113
Use Tax
For Tax Years 2007-08

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ISSUE

I. Use Tax—Manufacturing Exemption.

Authority: General Motors Corp. v. Indiana Dep't of State Revenue, 578 N.E.2d 399 (Ind. Tax Ct. 1991); IC § 6-2.5-2-1; IC § 6-2.5-3-2; IC § 6-2.5-5-3; IC § 6-8.1-5-1; [45 IAC 2.2-3-4](#); [45 IAC 2.2-5-8](#); [45 IAC 2.2-5-9](#).

Taxpayer protests the imposition of use tax on several items which it believes are exempt.

STATEMENT OF FACTS

Taxpayer is an Indiana sawmill. As the result of an audit, the Indiana Department of Revenue ("Department") determined that Taxpayer had not paid sales tax on all of its purchases which were subject to sales tax during the tax years 2007 and 2008. The Department therefore issued proposed assessments for use tax, interest, and ten percent negligence penalty. Taxpayer protests the imposition of use tax on most of those purchases which the Department determined were subject to sales or use tax. Taxpayer also protests the imposition of the negligence penalty. In order to toll the accrual of interest, Taxpayer paid the proposed assessments while maintaining its protest. An administrative hearing was conducted and this Letter of Findings results. Further facts will be supplied as required.

I. Use Tax—Manufacturing Exemption.

DISCUSSION

Taxpayer protests the Department's determination that some of Taxpayer's purchases of tangible personal property, including equipment and repair parts for the equipment as well as fuel for the equipment, in the tax years 2007 and 2008, were subject to sales tax but that sales tax had not been paid at the time of purchase. The Department therefore issued proposed assessments for use tax on those purchases. Taxpayer protests that some of the tangible personal property was used in its manufacturing process and was therefore exempt from sales and use tax. The Department notes that the burden of proving a proposed assessment wrong rests with the person against whom the proposed assessment is made, as provided by IC § 6-8.1-5-1(c).

The sales tax is imposed by IC § 6-2.5-2-1, which states:

(a) An excise tax, known as the state gross retail tax, is imposed on retail transactions made in Indiana.

(b) The person who acquires property in a retail transaction is liable for the tax on the transaction and, except as otherwise provided in this chapter, shall pay the tax to the retail merchant as a separate added amount to the consideration in the transaction. The retail merchant shall collect the tax as agent for the state.

The use tax is imposed under IC § 6-2.5-3-2(a), which states:

(a) An excise tax, known as the use tax, is imposed on the storage, use, or consumption of tangible personal property in Indiana if the property was acquired in a retail transaction, regardless of the location of that transaction or of the retail merchant making that transaction.

Also, [45 IAC 2.2-3-4](#) provides:

Tangible personal property, purchased in Indiana, or elsewhere in a retail transaction, and stored, used, or otherwise consumed in Indiana is subject to Indiana use tax for such property, unless the Indiana state gross retail tax has been collected at the point of purchase.

Therefore, when tangible personal property is acquired in a retail transaction and is stored, used, or consumed in Indiana, Indiana use tax is due if sales tax has not been paid at the point of purchase. In this case, the Department determined that Taxpayer had acquired tangible personal property in retail transactions and used that property in Indiana without paying sales tax at the point of purchase. The Department therefore issued proposed assessments for use tax, as provided by [45 IAC 2.2-3-4](#).

Taxpayer protests that its production process begins when standing trees are cut down and continues until the cut lumber is placed on trucks for delivery to its customers. Taxpayer believes that the equipment in question is used in that production process and is therefore exempt from sales and use tax. This exemption is found at IC § 6-2.5-5-3, which states:

(a) For purposes of this section:

(1) the retreading of tires shall be treated as the processing of tangible personal property; and

(2) commercial printing shall be treated as the production and manufacture of tangible personal property.

(b) Except as provided in subsection (c), transactions involving manufacturing machinery, tools, and equipment are exempt from the state gross retail tax if the person acquiring that property acquires it for direct use in the direct production, manufacture, fabrication, assembly, extraction, mining, processing, refining, or

finishing of other tangible personal property.

(c) The exemption provided in subsection (b) does not apply to transactions involving distribution equipment or transmission equipment acquired by a public utility engaged in generating electricity.
(Emphasis added).

As provided under IC § 6-2.5-5-3(b), items must meet the "double direct" test in order to qualify for exemption. Taxpayer believes that the items under protest meet this standard and qualify for the exemption. Taxpayer refers to [45 IAC 2.2-5-9](#) in support of its protest that the equipment is exempt from sales and use tax. Upon review, [45 IAC 2.2-5-9\(k\)](#) states:

(1) Extraction means the removal of natural resources, minerals, and mineral aggregates from the earth, pits, or banks.

(2) Mining includes commercial mining (both deep and surface mining), quarrying, gas and oil drilling, and any other commercial extraction of natural resources, minerals, and mineral aggregates from the earth. It also includes the extraction for commercial purposes of coal, clay, crushed and graded stone, gravel, sand, oil, natural gas, gypsum, slate, ore, and all materials and similar natural resources and mineral aggregates.

Therefore, the exemption described in [45 IAC 2.2-5-9](#) applies to tangible personal property used in mining or extracting natural resources from the earth.

The Department does not agree that cutting down trees is the same thing as mining, as provided in [45 IAC 2.2-5-9\(k\)](#). The trees in question in this protest are not extracted from the earth but rather are cut down above the earth. The roots and stump remain in the earth. Therefore, the creation of lumber from fallen trees constitutes a manufacturing process and the proper regulation to review is [45 IAC 2.2-5-8](#), which states in relevant parts:

(a) In general, all purchases of tangible personal property by persons engaged in the direct production, manufacture, fabrication, assembly, or finishing of tangible personal property are taxable. The exemption provided in this regulation [[45 IAC 2.2](#)] extends only to manufacturing machinery, tools, and equipment directly used by the purchaser in direct production. It does not apply to material consumed in production or to materials incorporated into tangible personal property produced.

(b) The state gross retail tax does not apply to sales of manufacturing machinery, tools, and equipment to be directly used by the purchaser in the direct production, manufacture, fabrication, assembly, or finishing of tangible personal property.

(c) The state gross retail tax does not apply to purchases of manufacturing machinery, tools, and equipment to be directly used by the purchaser in the production process provided that such machinery, tools, and equipment are directly used in the production process; i.e., they have an immediate effect on the article being produced. Property has an immediate effect on the article being produced if it is an essential and integral part of an integrated process which produces tangible personal property.

—EXAMPLES—

(1) Aluminum pistons are produced in a manufacturing process that begins, after the removal of raw aluminum from storage inside the plant, with the melting of the raw aluminum and the production of castings in the foundry; continues with the machining of the casting and the plating and surface treatment of the piston; and ends prior to the transportation of the completed pistons to a storage area for subsequent shipment to customers. Because of the functional interrelationship of the various steps and the flow of the work-in-process, the total production process, comprised of such activities, is integrated.

(2) The following types of equipment constitute essential and integral parts of the integrated production process and are, therefore, exempt. The fact that such equipment may not touch the work-in-process or, by itself, cause a change in the product, is not determinative.

...

(G) An automated scale process which measures quantities of raw aluminum for use in the next production step of the casting process in the foundry.

...

(4) Because of the lack of an essential and integral relationship with the integrated production system in Example (1), the following types of equipment are not exempt:

...

(G) Equipment used to remove raw materials from storage prior to introduction into the production process or to move finished products from the last step of production.

...

(g) "Have an immediate effect upon the article being produced": Machinery, tools, and equipment which are used during the production process and which have an immediate effect upon the article being produced are exempt from tax. Component parts of a unit of machinery or equipment, which unit has an immediate effect on the article being produced, are exempt if such components are an integral part of such manufacturing unit. The fact that particular property may be considered essential to the conduct of the business of manufacturing because its use is required either by law or by practical necessity does not itself mean that the property "has an immediate effect upon the article being produced". Instead, in addition to being essential for one of the above reasons, the property must also be an integral part of an integrated process which produces tangible

personal property.

–EXAMPLES–

(1) The manufacturing equipment utilized for the production of plastics consists of an interconnected system which contains among its components a coal fueled boiler, heat exchangers, vacuum jets, process heating vessels, distillation/stripping columns, related equipment, and piping. All elements of this integrated production process are exempt from tax.

...

(j) Managerial, sales, and other non-operational activities. Machinery, tools, and equipment used in managerial sales, research, and development, or other non-operational activities, are not directly used in manufacturing and, therefore, are subject to tax. This category includes, but is not limited to, tangible personal property used in any of the following activities: management and administration; selling and marketing; exhibition of manufactured or processed products; safety or fire prevention equipment which does not have an immediate effect on the product; space heating; ventilation and cooling for general temperature control; illumination; heating equipment for general temperature control; and shipping and loading.

(k) "Direct production, manufacture, fabrication, assembly, or finishing of tangible personal property" is performance as a business of an integrated series of operations which places tangible personal property in a form, composition, or character different from that in which it was acquired. The change in form, composition, or character must be a substantial change, and it must result in a transformation of property into a different product having a distinctive name, character, and use. Operations such as compounding, fabricating, or assembling are illustrative of the types of operations which may qualify under this definition.

....

(Emphasis added).

The Indiana Tax Court has addressed the question of what constitutes a manufacturing operation. In *General Motors Corp. v. Indiana Dep't of State Revenue*, 578 N.E.2d 399, 401 (Ind. Tax Ct. 1991), the Court provided:

The double direct standard, expressed in the statutory language emphasized above, is the touchstone of the equipment exemption from sales/use tax. In *Indiana Department of State Revenue v. Cave Stone, Inc.* (1983), Inc [sic], 457 N.E.2d 520, the seminal case interpreting the double direct standard, the Indiana Supreme Court recognized the essential and integral test to determine whether the double direct standard is met. The court held the transportation equipment at issue was both essential to transforming crude stone into a marketable product and integral to "the ongoing process of transformation." *Id.* at 524.

The court's inquiry focused on the production process itself, defining it broadly to encompass all the production steps involved in transforming work in process into a finished marketable product:

The [equipment exemption] statute circumscribes all of the operations or processes by which the finished product is derived. **Thus, we find that the production or processing of the stone begins at the time of the initial stripping, drilling, and blasting at the quarry and ends at the time the stone is stockpiled. The production process is continuous and indivisible.**

(Emphasis added).

The Court further provided:

The Department erroneously draws an artificial and arbitrary boundary based on the first marketable product to emerge rather than drawing the more logical line based on the actual end product produced. Under an approach focusing on the actual end product marketed, GM's packing materials used to transport component parts sold to non-GM manufacturers and those used to transport finished replacement parts would still be taxed. On the other hand, packing materials used to transport work in process parts from GM's component plants to GM's assembly plants would be exempt as an essential and integral part of GM's integrated production process of manufacturing finished automobiles. Finally, a determination that an integrated production process ends upon the completion of the actual end product marketed (the most marketable product) is wholly consistent with the legislative purposes of the exemption statutes to encourage industrial growth and to avoid tax pyramiding.

Id. at 405.

(Emphasis added).

In that case, General Motors had several component plants which made vehicle parts which were assembled at another General Motors plant. The Court determined that General Motors' integrated production process began at the various General Motors component plants and ended upon the completion of the actual end product marketed, which in General Motors' case was a finished vehicle, at another General Motors plant.

In the instant case, Taxpayer bought standing trees and hired third parties, including one entity with common ownership, to cut the trees down. Taxpayer did not cut down the trees itself. The third parties cut the trees down and Taxpayer would then drag the cut trees out of the forest with a skidder. Taxpayer then would cut the trees to length for loading onto its trucks which transported the logs to its sawmill. In the course of the protest process, Taxpayer provided documentation explaining and establishing the whole process of turning standing trees into finished lumber.

As explained by the Court in *General Motors*, the equipment exemption statute circumscribes all of the

operations or processes by which the finished product is derived. The Court also explained that the operations or processes, while conducted at several separate production facilities, were all those of a single entity. If General Motors had sold parts to third parties rather than using those parts in its own ongoing production process, the final product would be the parts and not a completed vehicle. Similarly, if General Motors had purchased parts from third party suppliers, the production of those parts would have been outside General Motors' production process.

Here, the standing trees were raw materials. Third parties cut the trees down, but they were still trees. Taxpayer's operations began after the trees were cut by third parties. As provided by [45 IAC 2.2-5-8\(c\)](#) example (2)(G), Taxpayer's production process starts at the point it cuts the trees into lengths for loading onto its trucks. This step is also required to allow the logs to fit into Taxpayer's debarker. The cutting down of the trees is performed by other parties and constitutes a service performed by those parties for Taxpayer. The dragging of the cut trees out of the forest constitutes the movement of raw materials prior to the production process. Taxpayer's cutting of the trees into logs for loading onto its trucks and into its debarker is the first step in which the raw materials begin their transformation into Taxpayer's finished product.

Therefore, some of the equipment under protest is used after the cutting of the trees into logs is used to move work in process during the production process and is exempt under [45 IAC 2.2-5-8](#). Units 67, 68, 72, and the repair parts and fuel consumed in their operations are used to move work in process and are wholly exempt. Unit 64 is used for a total of nine hours a day, with the last hour used in loading the finished product onto trucks for delivery to Taxpayer's customers. Therefore, Unit 64, repair parts, and fuel consumed in its operation are eighty-nine (89) percent exempt and eleven (11) percent taxable. Unit 62, its repair parts, and fuel consumed in its operation are used to move raw materials prior to the production process and are taxable. A supplemental audit will recalculate Taxpayer's liabilities for these years and will return the excess payment to Taxpayer.

FINDING

Taxpayer's protest is sustained in part and denied in part, as provided above.

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